

Economic Insights

Can Draghi's plan end the threat of Eurozone deflation?

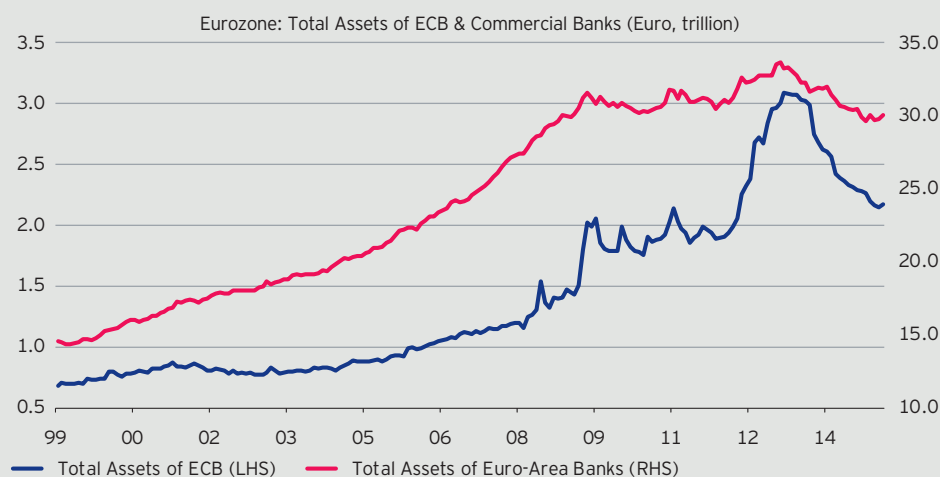
June 2014



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Europe has been facing increasing danger of deflation as prices deviate further and further below European Central Bank's (ECB) 2% target. For too long the ECB has been long on promises and short on delivery - the ECB and its president Draghi did too little to promote balance sheet expansion after the long-term refinancing operation (LTRO) programme of 2011-12. Since then, the ECB's balance sheet has contracted, and the balance sheets of commercial banks have also shrunk (see Chart 1).

Chart 1: Balance sheets of ECB and Euro-area commercial banks have been shrinking



Source: Thomson Reuters Datastream.

On 5 June 2014, the ECB finally announced a package of measures in an effort to combat deflation and stimulate the European economy. Although the package should help Euro-area equities in the short run, the longer term prospects of this package achieving a full recovery of Eurozone growth and inflation are remote.

Too little, too late?

The measures by the ECB were in three parts:

- 1) Interest rates cuts (reducing the main refinancing rate, the marginal lending rate and the imposition of negative rates on banks' excess reserve deposits at the ECB);
- 2) A plan to increase commercial bank lending via EUR 400 billion of targeted long term refinancing operations (TLTROs) and the ending of sterilisation on Securities Market Programme (SMP) (i.e. previous security or bond market purchases) which could amount to EUR 216 billion; and
- 3) The promise (again) that further quantitative easing (QE)-type measures (purchases of securitised loans) could still be taken.

ECB President Mario Draghi characterised his announcement as "significant", covering three areas:

- A. Easing monetary policy by supporting lending to the real economy;
- B. Enhancing the transmission mechanism; and
- C. Confirming that unconventional instruments will be used if necessary.

The new **TLTROs** are the heart of the programme. Banks will be allowed to borrow from the ECB, initially, 7% of their total loans outstanding on 30 April 2014 to the Euro-area non-financial private sector, excluding loans to households for house purchases. So the scheme is "targeted" at all business lending (not just small and medium enterprises), and deliberately excludes lending for home purchases. The first two tranches worth a combined EUR 400 billion will be made in September and December 2014. Then from March 2015 to June 2016 banks will be able to borrow, quarterly, up to **three times** the amount of their net new lending to the same targeted borrowers.

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However, I'd argue that the plan is **too little** because it only implies an initial potential expansion of the ECB's balance sheet of EUR 616 billion by December, just a small amount as compared with its current size of over EUR 2 trillion, although there could be more to follow from the TLTRO programme in 2015 and 2016. Also, the amount of new lending is to be decided by the banks, not by the ECB so the total could fall short of EUR 616 billion.

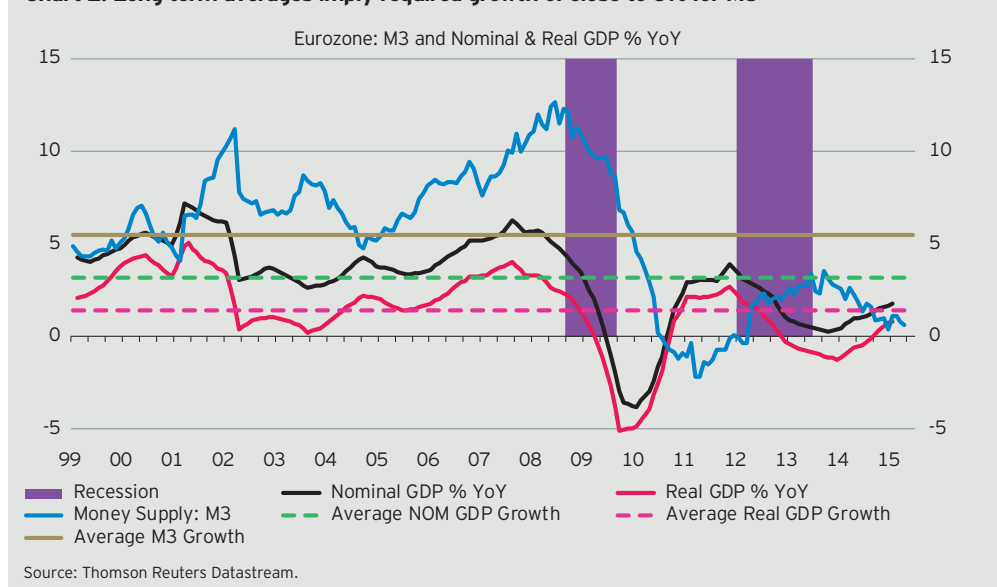
I would also argue that although the recently announced package of measures is a step in the right direction, it is clearly rather limited and **too late**. In saying this I have two specific points in mind. First, the lag in effect of monetary policy means that it will take at least **two years** before there can be any assurance the Euro-area inflation will be rising back towards 2%. Typically inflation is lowest in the early stages of a recovery so it would be very strange for inflation to be rising in 2015 (as forecast by the ECB) - within a year of the recent marked slowdown of money and credit growth.

Second, the seeds of deflation are already taking hold. In Belgium as well as in the big four Euro-area economies - Germany, France, Italy and Spain - producer prices are already falling. ECB staff including President Draghi claim that 80% of price weakness is due to falling commodity prices, but it is equally true to say that those price trends reflect weak demand in the Eurozone.

Faster rates of money and credit growth required for real GDP growth

To raise real GDP to an average close to the 1.5%, fifteen-year average shown by the pink dashed line in Chart 2, from its current 0.8% annual rate, and the nominal GDP growth rate to about 3.5% (1.5% real GDP plus 2%), faster rates of money and credit growth are required.

Chart 2: Long term averages imply required growth of close to 6% for M3



However, in the past 15 years while the Euro has been in existence the annual average decline in M3 velocity (Nominal GDP/M3) for the Euro-area has been -2.0% p.a. Intuitively this means that as nominal incomes rise across the Euro-area, households and firms are choosing on average to hold 2% greater cash and deposit balances every year relative to their income. One implication of the steady decline in velocity (until the crisis and the abrupt slowdown of the GDP in the numerator), or the choice to hold more money per unit of income, is that nominal GDP typically grows 2% less than M3 (on average, as shown in Chart 2). Another implication is that with growth of M3 averaging only 1.3% p.a. since June 2010, nominal GDP growth is likely to turn negative within the foreseeable future - unless there is strong monetary stimulus within the next year or so.

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At a minimum, the ECB should be aiming at a rate of monetary growth (for M3) that fully offsets the decline in velocity, and in addition, accommodates its targeted 2% inflation. Allowing also for a positive real economic growth rate of (say) 2% implies a desired or required growth rate of M3 of close to 6% p.a.

In summary, the package of measures from the ECB only starts to address the core problem: to ensure that the Euro-area's commercial bank balance sheets expand, and to ensure that M3 accelerates from its current inadequate pace. Regulatory pressures to satisfy the AQR (Asset Quality Review) will keep banks risk averse for much of this year, slowing balance sheet growth further. For this reason Draghi's statement that "We are not finished here," will almost certainly need to be acted upon. And if this package fails to lift the economies of the Eurozone, QE-style asset purchases will almost certainly follow.